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No. 524

In the Supreme Court of the United States

OCTOBER TERM, 1961

RAYMOND I. SMITH, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 72–97) are reported at 33 T.C. 141. The opinion of the Court of Appeals (Pet. v–xviii) is reported at 292 F. 2d 470.

JURISDICTION

The judgment of the Court of Appeals was entered on June 28, 1961. (Pet. xix.) The petition for a writ of certiorari was filed on October 30, 1961. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's finding that in 1953 and 1954 the taxpayer-

corporation permitted its earnings to accumulate beyond its reasonable needs for the purpose of preventing the imposition of the surtax on its sole stockholder, and therefore was liable in those years for the surtax imposed by Section 102 of the Internal Revenue Code of 1939 and by Section 531 of the Internal Revenue Code of 1954.

STATUTES INVOLVED

Section 102 (a) and (c) of the Internal Revenue Code of 1939 and Sections 531, 532(a), 533(a), 534 (a), (b), (c) and (e), 535(a), (c)(1) and (2), and 537 of the Internal Revenue Code of 1954 are set out in the Appendix, *infra*, pp. 12–16.

STATEMENT

The taxpayer-corporation is a Nevada corporation engaged in the business of operating bars on the premises of Harold's Club (hereinafter called the Club) in Reno, Nevada. The business had been started in 1944 as a sole proprietorship by Raymond I. Smith, the father of the owners of the Club (Harold S. and Raymond A. Smith) and, when the taxpayer-corporation was formed in 1946 to take over the bars, Raymond I. Smith became its sole stockholder. He owned no interest in the Club, which was separately incorporated, but was employed as the Club's general manager at a salary of $10,000 a year plus 20 percent of the net profits before taxes and salaries. His income from the Club ranged from $44,000 in 1941 to a high of $557,559.57 in 1953. (R. 73–76; Pet. App. vi–vii.)

Since its incorporation, the taxpayer-corporation has realized net income ranging from $101,052.13 in 1947 to a high of $278,630.70 in 1955. Despite its prosperity it has never paid a salary or dividends to its sole stockholder. Consequently, by the end of 1955 it had accumulated undistributed earnings in the sum of $781,475.25. (R. 61, 76–77; Pet. App. vii.)

During the period 1950 through 1954, the top bracket personal income tax rate of Smith and his wife averaged 87 percent. (R. 77; Pet. vii–viii.)

All of the taxpayer-corporation's patrons come solely from the Club and, accordingly, its efforts to promote its business are geared to increasing the number of the Club's customers. This also benefits the taxpayer-corporation's sole stockholder personally, since his compensation as the Club's general manager is based upon its net profits. (R. 79; Pet. App. viii.)

One such promotional outlay by the taxpayer-corporation, made in 1949, was for the purchase of a gun collection and memorabilia of the Old West, which were subsequently used to advertise the Club. Other expenditures were for the purchase of a motel in 1951 and the acquisition of a coffee shop in 1953, both of which were used for the accommodation of the Club's patrons. (R. 79–81, 83–84; Pet. viii-ix.)

In December 1953, the taxpayer-corporation purchased two parcels of farm land located approximately three miles south of Reno, on the main highway from Las Vegas, Carson City and the south end of Lake Tahoe. The total cost was $870,879.55. In 1954, the taxpayer-corporation purchased an addi-

tional 2½ acres of adjoining property for $110,096.80. The farm property had originally been offered to the Club but it was not in a position to make the purchase because it was then engaged in the construction of a seven story building at its downtown Reno location. (R. 85–86; Pet. ix.)

At the time the taxpayer-corporation made these purchases, it was aware, along with the Club, that competing interests were attempting to buy the property near Reno. The owners of the Club and the taxpayer-corporation felt that the Club should be protected against such competition and that desirable land might not be available later. At the time of the purchase, however, the taxpayer-corporation had no plans for the development of the property, and both it and the Club planned to develop the land only if at some future time it became necessary. The plan contemplated a large hotel, gambling casino, convention hall, all season swimming pool, golf course and some residential property, all at an anticipated cost of $10,000,000. In 1957 the taxpayer-corporation engaged an architect who presented preliminary plans and an estimate of $17,000,000 as the probable cost of the project. No blue prints for the project were ever prepared. Since its purchase of the land, the taxpayer-corporation has been leasing it to crop farmers. (R. 86–88; Pet. ix–x.)

As to the years 1953 and 1954, the Tax Court found that the taxpayer-corporation's earnings were accumulated beyond the reasonable needs of its business for

the purpose of preventing the imposition of the surtax on its sole stockholder—a finding which makes the corporation liable in those years for the surtax imposed by Section 102 of the Internal Revenue Code of 1939 and Section 531 of the 1954 Code. (R. 93–97.) The Court of Appeals affirmed. (Pet. App. xi-xviii.)

ARGUMENT

The decision below is correct and there is no conflict of decisions or other occasion for further review of the case by this Court. Decision turns on a factual finding in which both courts below concurred. In the last two terms this Court declined to review other cases involving the same issue and basically similar factual situations. *I. A. Dress Co.* v. *Commissioner,* 273 F. 2d 543 (C.A. 2d), certiorari denied, 362 U.S. 976; *Smoot Sand & Gravel Corp.* v. *Commissioner,* 274 F. 2d 495 (C.A. 4th), certiorari denied, 362 U.S. 976; *Dixie, Inc.* v. *Commissioner,* 277 F. 2d 526 (C.A. 2d), certiorari denied, 364 U.S. 827.

1. The case involves the application of Section 102 of the Internal Revenue Code of 1939 (Appendix, *infra,* p. 12) and its successor, Sections 531 through 537 of the Internal Revenue Code of 1954 (Appendix, *infra,* pp. 13–16), which impose a surtax upon a corporate taxpayer if it is availed of for the purpose of avoiding the imposition of surtax upon its shareholders by permitting earnings to accumulate instead of distributing them to shareholders in whose hands they would be taxed as dividends received. An ac-

cumulation beyond the reasonable needs of the business is expressly made sufficient to establish liability for the corporate surtax. (Section 102(c) of the 1939 Code; Section 533(a) of the 1954 Code.) Whether an accumulation is excessive (and therefore whether the corporation was availed of for the interdicted purpose) is of course a question of fact on which the trial court's findings are conclusive if supported by the evidence. *Helvering* v. *Stock Yards Co., supra,* p. 700; *Helvering* v. *Nat. Grocery Co.,* 304 U.S. 282, 295, rehearing denied, 305 U.S. 669.

Here the Tax Court concluded that the taxpayer-corporation's earnings and profits for the years 1953 and 1954 were accumulated beyond the reasonable needs of its business (R. 97). The Court of Appeals affirmed, stating (Pet. App. xviii) that the unchallenged subsidiary findings of the Tax Court are supported by "substantial affirmative evidence" and that the Tax Court's conclusions as to the excessive accumulation of earnings "are supported by the findings."[1] Such a finding concurred in by the two lower courts is entitled to finality. *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 51; *Comstock* v. *Group of Investors,* 335 U.S. 211, 214.

[1] The Tax Court also independently found (R. 96), on other evidence, that the taxpayer-corporation was availed of for the purpose of preventing the imposition of surtax on its sole stockholder, but the Court of Appeals treated this as an "alternative ground" for decision (Pet. App. xvi) and concentrated on answering taxpayer's attacks upon the Tax Court's conclusion that the corporation had accumulated earnings beyond the reasonable needs of its business.

At any rate, this case is no exception to the general rule, since the unchallenged subsidiary findings of the Tax Court reflect a number of factors supporting a conclusion that taxpayer's earnings were accumulated beyond the reasonable needs of its business. Its business was operating bars in the Harold Club. It had accumulated earnings of almost $440,000 at the beginning of 1953, and in each of the years 1953 and 1954 it had additional income of over $220,000. (R. 76.) In December of 1953 it purchased 339 acres of farm land for over $818,000 and in 1954 purchased an additional tract for over $110,000. (R. 85.) Its bar business was merely subordinate to the operation of the Harold Club. (R. 93, 95; Pet. App. xv.) And, while it was dependent upon customers of the Harold Club for patrons of its bar business, there was no reasonable relationship between that interest in the Club's prosperity and the size and nature of the land transactions which taxpayer entered into in the taxable years. (R. 94–95; Pet. App. xv.) The farm land purchases would benefit the Club more than taxpayer. (R. 95.) Taxpayer's commitments in connection therewith were entirely out of proportion to its working assets and annual income. (Pet. App. xv.) Under the purported plan for a $10,000,000 construction project on the land, a substantial portion of the farm land acreage was to be diverted to unrelated business activities (R. 86–87, 95) and even that plan was postponed indefinitely (R. 88). Taxpayer's plans for using its

farm land acquisitions in its business were at best vague and indefinite.[2] (R. 87–88, 94; Pet. App. xv.)

2. Taxpayer's assertion that the case presents an important question which should be settled by this Court (Pet. 9–16) refers to the question of which party—the Commissioner or the taxpayer—has the burden of proving whether taxpayer's earnings were accumulated beyond the reasonable needs of its business. That question is not in issue. The Tax Court did not state which party had the burden of proof; it simply made findings, which are unchallenged, and concluded from those findings that in 1953 and 1954 taxpayer's earnings were accumulated beyond its reasonable needs. (R. 93–97.) On appeal the court below agreed with taxpayer's contention that the burden of proof was on the Commissioner (Pet. App. xii–xiii) but it rejected, after careful consideration, taxpayer's further contention that the Tax Court had placed the burden on taxpayer instead of the Commissioner and that that placement of the burden had influenced the result (Pet. App. xi–xiv, xvi–

[2] Aside from the question of excessive accumulation of earnings, the following additional evidence further indicates that taxpayer was availed of for the purpose of permitting the imposition of surtax on its sole stockholder: Subsequent to its incorporation, taxpayer never paid any dividends (R. 77); its sole stockholder was in high income tax brackets during the taxable years (R. 77); the stockholder was able to effect a tax saving of approximately $80,000 in 1953 and $100,000 in 1954 by reason of taxpayer's failure to declare dividends (R. 153); and, as a result of taxpayer's failure to ever declare a dividend, its accumulated earnings and profits increased from approximately $63,000 to approximately $640,000 in just eight years (R. 61).

xvii). Thus, the court below concluded that the Tax Court's views as to the burden of proof, "whatever those views may have been" (Pet. App. xiv), did not play any part in its conclusion that taxpayer's earnings were excessively accumulated in 1953 and 1954 (Pet. App. xiv) and that "the conclusions stated in the opinion of the Tax Court are supported by the findings of fact and give correct application to the governing statutes" (Pet. App. xvii). If these holdings are correct, as we believe, there is no necessity for this Court to review the burden of proof question or any of the other "provocative aspects" of the case (Pet. 22) suggested by taxpayer.[4]

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[4] In relation to the burden of proof question, taxpayer also suggests (Pet. 21) that, for the benefit of the Tax Court, this Court should clarify its prior decisions in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, and *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282. This, however, is but another way of requesting review on the burden of proof question, for the 1954-1955 amendments which the court below considered and held to shift the burden of proof to the Commissioner (Pet. App. xii–xiii, xvi) had not been enacted when those cases were decided.

Taxpayer also asserts (Pet. 16–19) that the court below sanctioned improper procedure on the part of the Tax Court and was also itself guilty of improper procedure in failing to remand the case to the Tax Court with instructions for reconsideration in the light of its holding that the Commissioner had the burden of proof. The first argument assumes (Pet. 16), contrary to fact, that the Tax Court tried the case as if the burden of proof were not on the Commissioner. The other argument (Pet. 17–19) amounts only to an attack upon the correctness of the holding below that the Tax Court's findings support its conclusion that taxpayer's earnings were accumulated beyond the reasonable needs of its business.

3. Taxpayer's claims of conflict between the circuits (Pet. 19–21) are frivolous. Even if it were material, there is no indication that the court below departed from the accepted postulate that a factual question is presented in the application of the statutes imposing the accumulated earnings surtax. While the court below stated that there was presented for decision "the resolution of mixed questions of fact and law" (Pet. App. xiv), that statement implies no more than that there is always present, even in basically "factual" issues, the question whether the trier of fact has applied the proper legal standard to the facts.

The alleged conflict as to the "effect" of certain facts (Pet. 20–21) is based upon two erroneous assumptions—first, that the Tax Court gave "controlling weight to the circumstance that more taxes would have been paid by its shareholder had petitioner paid dividends" (Pet. 21) and, second, that there are no other facts to support the factual conclusion concurred in by both courts below. Since the premise that there are no other facts to support the finding is, as we have shown, unsound, the claim of conflict based on that premise is equally unsound.

CONCLUSION

The decision below is correct and no conflict of decisions or important question is presented. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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NOVEMBER 1961.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.)

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) [As amended by Sec. 103(d), Revenue Act of 1941, c. 412, 55 Stat. 687] *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * * *

(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

* * * * *

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.)

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * * * *

SEC. 534. BURDEN OF PROOF.

(a) *General Rule.*—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allega-

tion that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) [As amended by Sec. 5 of the Act of August 11, 1955, c. 805, 69 Stat. 689] *Notification by Secretary.*—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) *Statement by Taxpayer.*—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

* * * * *

(c) [As amended by Sec. 4 of the Act of August 11, 1955, *supra*] *Application of Section.*—

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) *Definition.*—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

* * * * *

(c) *Accumulated Earnings Credit.*—

(1) *General rule.*—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) *Minimum credit.*—The credit allowable under paragraph (1) shall in no case be less

than the amount by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

* * * * *

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

U.S. GOVERNMENT PRINTING OFFICE: 1981